



NEWS RELEASE

CALIFORNIA STATE TREASURER PHIL ANGELIDES

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**TREASURER ANGELIDES AND LEGISLATIVE FISCAL LEADERS
ANNOUNCE MULTI-PRONGED PLAN TO IMMEDIATELY CLOSE \$386
MILLION IN CORPORATE TAX LOOPHOLES AND REQUIRE ANNUAL
BUDGET REVIEW OF TAX BREAKS**

*With Corporate Tax Burden Shrinking Dramatically Over Past Two Decades,
Angelides and Lawmakers Vow to Fight For Budget Priorities
That Ensure Responsibility, Fairness and Opportunity*

SACRAMENTO, CA - State Treasurer Phil Angelides and a group of lawmakers led by Assembly Budget Committee Chair Darrell Steinberg – joined by students and children's health advocates – proposed today the closing of an initial set of \$386 million in unjustified corporate tax loopholes as part of a multi-pronged plan to advance fiscal responsibility, promote budgetary fairness and expand opportunity for all Californians.

"It is wrong for the Governor's budget to propose damaging cuts to higher education, transportation and children's health programs - investments that are vital to the future prosperity of our State's economy - without even attempting to close one corporate tax loophole," Angelides said at a morning news conference here on the front steps of the Jesse M. Unruh State Office Building. "Cutting such critical investments - without first considering more responsible alternatives - means sacrificing opportunities for young people and endangering the very quality of life that is key to our economic competitiveness."

Steinberg (D-Sacramento) noted that for every dollar the state loses through tax breaks and loopholes, another dollar must be cut from state programs or added to the burden of other taxpayers. "Dollars from tax breaks and loopholes should be subjected to the same scrutiny as every other dollar in the budget," said Steinberg. "Every dollar that we save by closing a tax loophole can be used to protect essential services or reduce the need for new revenues to balance the budget."

In addition to Steinberg, the eight other lawmakers are Senate Appropriations Committee Chair Dede Alpert (D-San Diego), Senate Revenue & Taxation Committee Chair Gil Cedillo (D-Los Angeles), Assembly Budget Subcommittee #4 (State Administration) Chair Rudy Bermúdez (D-Norwalk), Assembly Appropriations Committee Chair Judy Chu (D-Monterey Park), Assembly Judiciary Chair Ellen Corbett (D-San Leandro), Assembly Environmental Safety & Toxic Materials Committee Chair John Laird (D-Santa Cruz), Assembly Public Employees, Retirement & Social Security Committee Vice-Chair Lloyd Levine (D-Van Nuys), and Assembly Jobs, Economic Development & The Economy Committee Chair Mark Ridley-Thomas (D-Los Angeles). Also lending her support was Carole Migden, Chair of the state Board of Equalization.

As proposed, the three-pronged strategy announced today would do the following:

- Immediately close an initial set of eight tax loopholes that benefit a few favored businesses and taxpayers (see attached fact sheet). Angelides and the lawmakers said these particular loopholes do not benefit the California economy overall and are unjustified at a time when the State is facing a severe budget crisis. The eight loopholes represent a combined \$386 million annually in lost tax revenue.
- Require the Governor each year to identify all tax loopholes in his proposed budget, in the same way that all other spending must be identified. The Governor's budget would be required to explain the purpose of each tax loophole, provide data on whether it is meeting that purpose, and recommend to the Legislature whether each loophole should be continued, modified or repealed. In addition, legislative fiscal committees would be required to annually review those recommendations as budget priorities and weigh the value of the loopholes - as expenditures - against spending for other state programs, such as education, healthcare, and capital investment.
- Require the state Franchise Tax Board (FTB) to re-examine the "water's-edge election" that large multinational corporations today employ to reduce their California taxes by \$400 million a year. The FTB would be required to report to the Legislature by September 1, 2005, on, among other things, whether corporations are moving income offshore and whether changed global economic conditions and the diminishing yield of the corporation tax require changes in the water's-edge election.

The Treasurer and lawmakers pointed out that the corporate tax burden in California has shrunk dramatically since 1990, due largely to the enactment since then of nearly five dozen tax loopholes worth \$2 billion a year in lost revenue. Those loopholes have helped shift a disproportionate share of the corporation tax burden to individual taxpayers and the regressive state sales tax. Although the legal corporate tax rate today in California is 8.84 percent, studies have shown that corporations in 2002 paid an effective tax rate of only 5.3 percent, the lowest in a half-century.

"In the midst of this State's budget crisis," Angelides said, "fiscal responsibility and fairness dictate that we root out these wasteful loopholes. California cannot afford to slash high-priority investments while leaving low-priority corporate tax loopholes on the books. The Governor should not ask for sacrifices only from those least able to bear them – children who need healthcare and young people seeking a college education."

The Treasurer and the lawmakers said that in the face of a \$14 billion budget deficit that the State faces in the coming 2004-05 fiscal year, which begins July 1, the \$386 million generated by these loophole closings would eliminating the need for damaging cuts in areas such as higher education and healthcare. For example, with \$386 million of additional revenue, California could avoid all of the following Governor's proposals to:

- Eliminate University of California (UC) and California State University (CSU) outreach programs for low-income and disadvantaged students (\$60.6 million).
- Turn away 21,000 eligible students from enrolling at UC and CSU (\$45.9 million).
- Increase California Community College fees by 44 percent (\$73.4 million).
- Reduce the eligibility of middle-class students for Cal Grants (\$11.2 million).
- Cut UC research funding by 5 percent (\$11.6 million).
- Raise UC and CSU graduate fees by 40 percent on the next generation of aspiring scientists and teachers (\$106 million).
- Capping enrollment in the Healthy Families program, preventing 159,000 children from getting health insurance (\$31.5 million).

"When you add up the numbers, it becomes crystal clear: California must restore fiscal responsibility by seeking a fair balance between spending cuts and restoring revenue lost through now unjustified tax cuts," Angelides said.

The eight specific corporate tax loopholes that Angelides and lawmakers are targeting for closure include a current provision that allows Californians to avoid paying the sales tax on yachts, aircraft and other vehicles if they purchase them in a state without sales tax and store it there for at least 90 days. This loophole costs California \$56.2 million annually in lost revenue. Currently, AB 694, introduced by Assemblymember Levine, would close this loophole.

Three other loopholes - a sales tax exemption for farm and timber machinery, for diesel fuel used only in agriculture, and for liquid petroleum fuel used only in agriculture - cost the State a combined \$103.6 million annually in lost revenue. These loopholes – enacted in 2001 to win the votes of four rural Republican legislators for the 2001-02 budget – are especially egregious because they were enacted as California was falling into its current budget crisis.

And the largest loophole that Angelides and the lawmakers are proposing to close - limiting the corporate tax-saving Subchapter S filing status, originally intended for small businesses, to firms with gross receipts under \$50 million - would produce revenue gains for the State of \$50 million in 2004-05, and \$175 million in 2005-06. (Subchapter S corporations pay California taxes on their corporate income at a reduced rate of 1.5 percent, instead of the regular 8.84 percent Bank and Corporation Tax rate.)

This loophole closing would affect only 2,000 corporations – less than 0.4 percent of the more than 500,000 corporations filing in California.

Other loopholes targeted for closure (and their current annual price tag for lost revenue) include: a special resource depletion reduction for oil and gas companies (\$11 million); provisions of state tax law that allow corporations to avoid paying state tax on the sale of certain assets and subsidiaries (\$30 million); and a corporate tax loophole for expatriate companies that relocate offshore - in name only - to tax havens like Bermuda and the Cayman Islands (\$10 million). Currently, AB 2584, introduced by Assemblymember Chu and sponsored by the Treasurer, would close the expatriate company loophole.

In addition to the legislative package that will be introduced to close the eight specific loopholes, Angelides and the lawmakers also proposed that the Governor and the Legislature review all loopholes annually as part of the budget process. Assemblymember Ridley-Thomas has introduced a similar proposal, AB990, sponsored by Board of Equalization Chair Migden, which would require the state Department of Finance to issue an annual report on tax loopholes.

Unlike the traditional spending proposed annually in state budgets, tax loopholes are not subject to regular review and re-approval. The Legislature and successive governors have approved such loopholes to deal with a perceived problem, or because of lobbying by a politically powerful group. Over the years, these decisions have results in dramatically increased costs to taxpayers.

According to the Department of Finance, the Legislature and successive governors have enacted 56 tax loopholes of \$5 million or more between 1990 and 2001, with a total annual revenue cost to the state of \$2 billion. This represents a significant slice of the \$8 billion in current year revenue loss from all tax cuts – excluding the reduction of the vehicle license fee – enacted since 1991. The bulk – an estimated 77 percent of those tax cuts – has benefited corporations and the wealthiest Californians.

NOTE: Please visit the Treasurer's Office website (www.treasurer.ca.gov) for additional information about today's announcement, including an executive summary, charts and a comprehensive fact sheet on the "Closing Corporate Tax Loopholes" proposal.

OFFICE OF THE TREASURER

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Closing Corporate Tax Loopholes:
*Advance Fiscal Responsibility, Promote Fairness and
Protect Investments in California's Future*

EXECUTIVE SUMMARY**▪ The Problem**

California faces a budget deficit of more than \$14 billion for the 2004-05 year. To close it, the Governor has proposed cuts in, among other areas, higher education, transportation and Healthy Families, investments vital to the future prosperity of all Californians. It is not right to cut these critical investments, sacrificing opportunities for young people and endangering the quality of life upon which California's economic competitiveness rests, without even attempting to close one corporate tax loophole. California needs a better approach, one that advances fiscal responsibility while promoting fairness and expanding opportunity.

In the budget crisis, California should not, as a first resort, make cuts in public services and investments that build its economic strength. Between 1990 and 2001, the Legislature and successive governors enacted 56 tax loopholes of \$5 million or more, with a total annual revenue loss to the state of \$2 billion. This represents a significant share of the \$8 billion in current year General Fund revenue loss from all tax cuts, excluding the Vehicle License Fee reduction, enacted since 1991. Seventy-seven percent of that benefit flows to the wealthiest Californians and corporations. (See Attachment A.)

California cannot afford to slash high-priority investments while leaving low-priority tax loopholes on the books. The budget should not ask for sacrifices only from those least able to bear them.

▪ The Background

According to a recent study (*State Tax Notes*, Nov. 17, 2003) by Allen Prohofsky, an economist with the Franchise Tax Board (FTB), California corporate tax liabilities fell from 0.62 percent of gross state product in 1988 to 0.44 percent in 2001. Meanwhile, corporate pretax profits as a share of national income rose from 7.3 percent in 1988 to 10.7 percent the fourth quarter of 2003. In 1988, the corporate income tax accounted for 16 percent of the revenue from California's "big three" tax sources (bank and corporation tax, personal income tax and sales tax); in 2001, it accounted for just 8.5 percent of "big three" revenues. Although the nominal corporation tax rate is 8.84 percent, corporations in 2002 paid an effective tax rate of 5.3 percent, the lowest in a half century.

This decline in the corporation tax has moved more of the tax burden to others. In 2002, non-elderly California families in the bottom 20 percent of the income distribution paid a higher percentage of their incomes in state and local taxes (11.3 percent) than did the top 1 percent of earners (10.6 percent), according to the Institute for Taxation and Economic Policy.

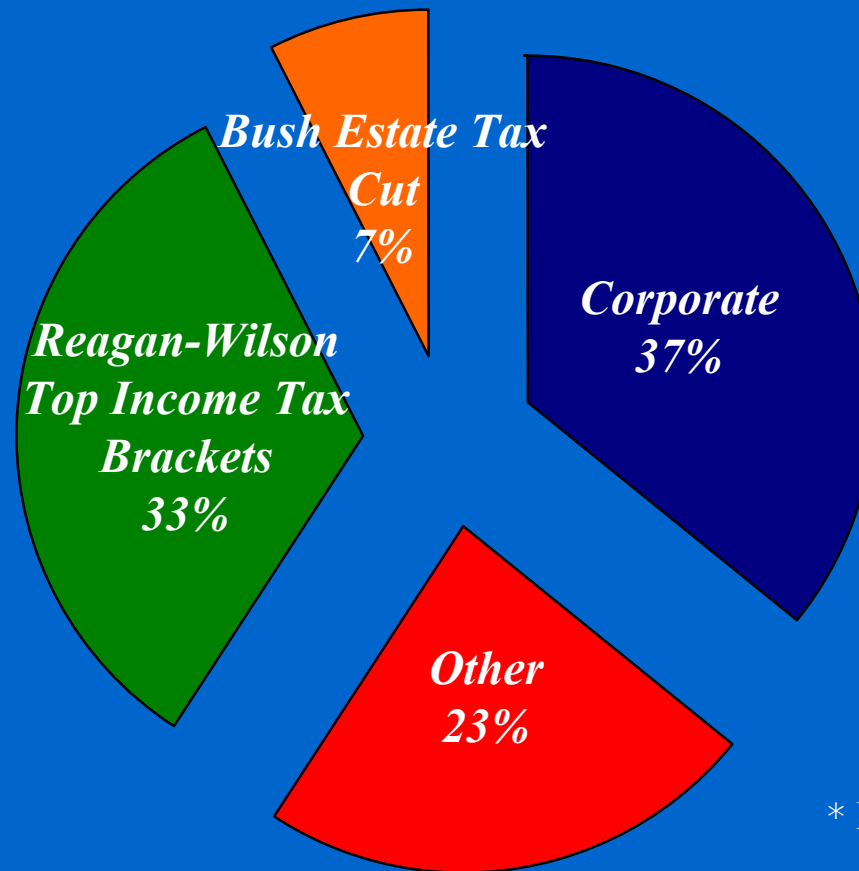
▪ **The Proposal**

State Treasurer Phil Angelides proposes a three-part strategy to begin closing tax loopholes:

1. **Close eight loopholes now.** Immediately close eight specific loopholes, which cost the State \$386 million a year in revenue. (See Attachment B.) These loopholes benefit a few favored businesses or taxpayers but do not help the California economy overall and are unjustified in a time of budget crisis.
2. **Review tax loopholes as part of the budget.** Require the Governor to identify all tax loopholes in his annual budget submission, report on the purpose of each tax loophole, provide data on whether it is meeting that purpose, and recommend to the Legislature whether it should be continued, modified or repealed. Legislative fiscal committees shall annually review those recommendations as budget priorities and weigh the value of loopholes against other state programs and the need for fiscal responsibility.
3. **Study the water's-edge election for multinational corporations.** Require the FTB to reexamine the water's-edge election used by large multinational corporations to reduce their California taxes by \$400 million a year. The FTB would report on, among other things, whether corporations are moving income offshore and whether changed international economic conditions and the declining yield of the corporation tax require changes in the water's-edge election. The report would be due September 1, 2005.

The revenues gained from the proposed set of initial loophole closings could, for example, reopen the doors of the University of California and California State University to the 22,000 eligible students who would be closed out by the Governor's budget proposal. It would also permit restoring college outreach programs eliminated by the Governor that help students become the first in their family to attend college, as well as avoiding the Governor's proposal to raise fees by 40 percent on the graduate students seeking to become California's future technological innovators, researchers and teachers. (See Attachment C.) Over the longer term, an annual budget review of loopholes will help restore revenue California has lost over the last decade, helping to bring the State back to fiscal balance in a way that promotes fairness and opportunity for California's people.

\$8 Billion Lost
2003-04 General Fund revenue loss
from tax cuts passed since 1991*



* Excludes Vehicle License
Fee Reduction

Closing Corporate Tax Loopholes:
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EIGHT LOOPHOLES TO CLOSE NOW

<u>Loophole closing proposal</u>	<u>Annual revenue loss (in millions)</u>
1. Close the “yacht loophole.”	\$56.2
2. Eliminate special resource depletion deductions for gas and oil companies.	\$11
3. Keep small business Subchapter S tax break for small businesses alone.	\$175
4. Repeal sales tax exemption for farm and timber machinery.	\$72.7
5. Repeal sales tax exemption for diesel used in agriculture.	\$17
6. Repeal sales tax exemption for liquid petroleum gas used in agriculture.	\$13.9
7. Close the expatriate corporation loophole.	\$10
8. Close the “nowhere income” corporate loophole.	\$30
TOTAL	\$385.6

What \$386 million lost to loopholes could buy in the 2004-2005 budget

With \$386 million, California could avoid the Governor's proposals:

- Abolishing General Fund support for University of California and California State University outreach programs that help lower-income students become the first in their families to go to college (\$110 million.)
- Turning 22,000 eligible students away from enrolling at UC and CSU (\$45.9 million).
- Increasing California Community College fees by 44 percent (\$73.4 million).
- Reducing the eligibility of middle-class students for Cal Grants (\$11.2 million).
- Reducing UC research funding from General Fund by 5 percent (\$11.6 million).
- Raising UC and CSU graduate fees by 40 percent on the next generation of aspiring scientists and teachers. (\$106 million).
- Capping enrollment in Healthy Families, preventing 159,000 children from getting health insurance (\$31.5 million).

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FACT SHEET**The Proposal**

State Treasurer Phil Angelides proposes a three-part strategy to begin closing tax loopholes:

1. Close eight loopholes now

Immediately close eight specific loopholes that benefit a few favored businesses or taxpayers but do not help the California economy overall and are unjustified in a time of budget crisis. These eight loopholes currently cost California \$386 million in lost revenue. (See attachment B.)

- **Close the “yacht loophole”**

California law requires its residents to pay use tax on tangible personal property they purchase out-of-state but store, use, or consume here. Current law, however, has a loophole big enough to float a yacht through. It permits California residents to buy a vehicle, aircraft or yacht out of state in a jurisdiction without sales tax, store it there for 90 days, then bring it into California without paying use tax.

The 90-day rule was originally enacted so that persons who move to the state with recently purchased cars or other property would not be unfairly hit with use tax, and to assure that California residents who purchase a vehicle or boat out of state, for use at an out-of-state residence or business, would not be liable for tax on it if they subsequently bring it to California. But vendors of expensive boats are now marketing the exemption as a loophole. They sell yachts to California residents but make delivery in Mexico, where the boat is first used and stored for 90 days, then sailed to California for permanent use here.

AB 694 by Assemblyman Lloyd Levine, currently stalled in the Senate, would close the “yacht loophole.” It would require California residents to pay use tax on out-of-state purchases of vehicles, boats and aircraft if the property is used in California for more than six months in the first year after purchase, if the vehicle is subject to registration in

California during the first year or if the boat or aircraft is subject to property tax in California during the first year. The property would not be subject to use tax if the purchaser could document that it was used outside of California for the first year.

Justification: Proponents of the loophole contend that it is not a loophole, but simply a “tax-planning opportunity.” Operators of business aircraft say it will complicate their record keeping and discourage them from keeping or repairing aircraft in the state.

Rebuttal: AB 694 does not apply to vehicles, vessels and aircraft used in interstate and foreign commerce; its target is tax avoidance on purchase of luxury goods for personal use. It clarifies that aircraft purchased out of state and flown into the state for repairs are not subject to use tax if they have been flown more than 25 hours. There is no doubt that Californians who buy a car to drive to work or a bass boat to fish on a nearby lake must pay sales and use tax on their purchases; Californians who buy luxury goods like yachts and use them here should have that same obligation to pay a tax that helps supports the waterways, roads and parks that they use and the investments in education and public services we all depend upon.

Revenue effect: According to estimates by the Board of Equalization, closing the yacht loophole will increase revenues by \$56.2 million a year.

- **Eliminate special resource depletion deductions for gas and oil companies**

California allows taxpayers to deduct annually a specified percentage of the income from some oil and gas wells as a depletion allowance. The deduction is 22 percent for regulated domestic natural gas, 10 percent for natural gas from geopressured brine, and 15 percent for oil and gas from certain independent producers. Unlike cost depletion, which allows a taxpayer to offset the actual costs of discovering and developing a resource over the time a well is producing, the percentage depletion method gives the taxpayer a deduction potentially in excess of cost recovery. It acts as a tax subsidy, increasing the rate of return to certain oil and gas projects at public expense.

Justification: Finding and drilling for oil and gas is a highly risky activity, and a subsidy is necessary to encourage independent producers to develop domestic energy resources to reduce dependence on foreign oil.

Rebuttal: All enterprises are risky, and there is little evidence that the market fails to adequately reward those who take risks on oil and gas development or calls forth too little investment in this sector, as evidenced by the success of large oil companies. It is also unlikely that this California tax subsidy to exploration and production has any appreciable effect on the level of drilling activity around the United States.

Revenue effect: This loophole currently costs \$11 million a year.

- **Keep small business Subchapter S tax break for small businesses alone**

State law allows eligible small business corporations to elect to pay taxes as S corporations. S corporations pay California taxes on their corporate income at a reduced rate of 1.5 percent instead of the 8.84 percent Bank and Corporation Tax rate, and they are not subject to the corporate Alternative Minimum Tax. Individual shareholders of an S corporation pay personal income taxes on their pro-rata share of the corporation's income.

To be eligible to elect S corporation status, a firm must have made a valid federal S corporation election in place and must have fewer than 75 shareholders. In the 2001 tax year, 202,076 corporations filed as S corporations, reporting \$5.1 billion of California apportioned income. Another 317,980 corporations filed as C corporations subject to the normal bank and corporation tax.

Justification: Subchapter S status allows small businesses to take advantage of the limited liability status of being a corporation while paying lower taxes than they would if they filed as a regular C corporation. This encourages entrepreneurship and contributes to job creation in California.

Rebuttal: Subchapter S status does help small businesses, but the help should be limited to small and growing firms. Corporations with annual gross revenues greater than \$50 million are well established, and should not be able to avoid corporate taxation. Limiting S status to companies below that threshold would affect only 2,000 of the 202,076 current S corporation filers, less than 1 percent of all S corporations filing in California and less than 0.4 percent of all corporations. Previous bills have proposed putting the ceiling on S corporations at annual gross revenues of \$20 million. Setting the threshold at \$50 million assures that this proposal would not harm genuinely small businesses or growing new firms. Currently, about 200 corporations with total annual receipts over \$500 million receive more tax benefit from Subchapter S status than the 150,000 S corporations with receipts under \$1 million.

Revenue effect: Limiting Subchapter S status to firms with gross receipts under \$50 million would produce revenue gains of \$50 million in 2004-05 and \$175 million in 2005-06.

- **Eliminate 2001 Sales Tax Exemptions for Equipment, Diesel Fuel and Liquid Petroleum Gas Used in Agriculture**

To win the votes of four rural Republican legislators for the 2001-02 budget, the Legislature passed AB 426, providing sales tax exemptions for liquid petroleum gas, farm and timber equipment, diesel fuel used in farming activities. The exemptions would not have passed as standalone legislation. These exemptions give benefits to agriculture not enjoyed by many other taxpayers.

Justification: Proponents of these exemptions argue that agriculture is an economically important but distressed industry in California that deserves special assistance. They point out that 33 other states provide a sales tax exemption for farm equipment, and that natural gas, a fuel used in urban areas, is already exempt from the sales tax.

Rebuttal: There is no reasonable economic argument that these loopholes make a vital difference for California's \$27 billion agribusiness sector. The industry already receives large direct federal farm subsidies, enjoys subsidized water and receives other special tax breaks, such as Williamson Act property tax reductions. Although farm equipment is exempt from sales taxes in 33 states, it is taxed in 12 other states; there is no uniform policy agreement on exemption. And though it is true that natural gas is exempt from the sales tax, in many urban jurisdictions it is subject to local utility taxes, which, like the sales tax, are a consumption tax. There is no good reason that LPG, which is not subject to utility taxes, should be given an exemption from all consumption taxation.

These loopholes are especially egregious because they were enacted as California was falling into its budget crisis, costing the State revenue at the moment when it did not have enough to cover its highest priority services, including higher education, transportation and health care for children.

Revenue effect: The agricultural sales tax exemptions passed in 2001 cause an annual revenue loss of \$105 million, according to the Board of Equalization.

- **Close the expatriate corporation loophole**

AB 2584, introduced by Assemblymember Judy Chu and sponsored by State Treasurer Phil Angelides, will prevent publicly traded U.S. corporations from evading their fair share of California taxes by relocating offshore – in name only – to locales such as Bermuda and the Cayman Islands.

The U.S. Treasury Department has noted “a marked increase recently in the frequency, size and profile” of paper-only corporate relocations to offshore tax havens such as Bermuda and the Cayman Islands. A handful of U.S.-based companies, eighteen out of more than 8,000 publicly traded U.S. corporations, have restructured as foreign corporations in lax offshore havens. These corporate expatriates maintain their headquarters and operations in the United States, enjoying the benefits of operating as U.S. companies, but avoid federal and State taxes and skirt legal protections for investors. This practice is unfair to other companies that meet their corporate responsibilities and pay their fair share of State and federal corporate income taxes.

“Expatriate corporations” use practices such as “corporate inversions” to transform themselves into nominally foreign companies. For example, they establish a subsidiary in a foreign tax haven, then have that subsidiary “buy” the parent company. This paper transaction leaves the company with its operations and headquarters in the United States, but changes its nominal legal home to the tax haven. Many expatriate corporations

transform significant amounts of their worldwide income from U.S.-based income to foreign-based income through “earnings stripping” transactions. In these transactions, the U.S.-based subsidiary makes deductible payments (such as interest, management fee, or royalty payments) to the new sheltered “foreign” parent. These payments, then, reduce their effective rate of U.S. and California taxation by reducing their net income subject to taxes.

Under California’s current corporate tax system, corporations with operations in the State can choose between two methods of computing the income on which they will pay their State corporate income taxes – the “worldwide” method or the “water’s edge” method. The Franchise Tax Board estimates that approximately 75 percent of expatriate corporations filing in California elect the “water’s edge” method. Because an expatriate corporation can transform a large portion of its worldwide income from U.S.-based income to foreign-based income, continuing to allow the use of the water’s-edge method permits these companies to reduce the net income on which the California share of corporate income is based and taxed. The bill would prohibit expatriate corporations from utilizing the water’s-edge election under California corporate tax law to shield certain foreign-based income from California tax. This legislation would effectively preclude these companies from artificially excluding U.S.-based income from taxation.

Justification: Opponents of this measure last year claimed it was a tax increase.

Rebuttal: The proposal would simply require that these eighteen expatriate companies pay their fair share of state taxes like thousands of publicly traded companies and hundreds of thousands of California small businesses. An expatriate corporation receives the same public services as its competitors and enjoys all the benefits of operating in the United States, but can shift the burden of paying for those services to more responsible companies and their shareholders. In Congress, Sen. Charles Grassley, R-Iowa, the chairman of the Senate Finance Committee, has been trying, so far without success, to end this basic unfairness. “The average individual taxpayer can’t skip out on his tax bill,” Grassley notes. “He doesn’t have the luxury of setting up a filing cabinet and a mailbox overseas to escape his federal taxes. The same should be true for corporations.”

Revenue effect: According to the Franchise Tax Board, California will lose an estimated \$132 million over the next 10 years – as the result of corporate expatriations that have already occurred. This bill would stem these losses, saving approximately \$99 million that would otherwise be lost to expatriations. If the number of corporations that expatriate continues to grow at the rate of the past 10 years, California will lose an estimated \$180 million in tax revenues over the next 10 years.

- **Close the “Nowhere Income” Loophole**

The tax rules for apportioning the income of multi-state corporations are meant to assign all of a firm’s income, no more or no less, among the states in which it does business.

California's practice of allowing separate Section 338 elections for State and federal purposes allows corporations to create "nowhere income" that escapes state taxation.

Under Section 338 of the Internal Revenue Code, when a corporate subsidiary is sold by one corporation to another, the buyer and seller, for tax purposes, may elect to treat the sale of stock in the subsidiary as a sale of assets. Conforming to federal law, California allows the same election. But California alone allows corporations to make a different Section 338 election for state tax purposes than for federal. This separate election creates the opportunity for "nowhere income" that escapes state taxation in any state.

Example: Corporation A, domiciled in California, sells a subsidiary that does business only in Wisconsin, to Corporation B. For federal purposes, the buyer and seller treat the transaction as a stock sale. But Corporation A takes a separate Section 338 election for California tax purposes, treating the transaction as an asset sale. Wisconsin, acting under the rules assigning corporate income among states, considers the capital gain from the sale of the stock as non-business income entirely allocated to California, the home of Corporation A, and not taxable in Wisconsin. But for California tax purposes, Corporation A elects to treat the sale as a sale of assets, with the gain considered business income. Since the Wisconsin subsidiary does no business in California and has no sales, workers or property here, the business income generated from the gain on the sale of assets is not subject to taxation in California. Thus the corporation, thanks to the separate election, escapes taxation on its income from the sale in either state.

Justification: Corporate opponents of closing the "nowhere income" loophole say that it makes up for California's failure to conform fully with federal tax law on issues such as accelerated depreciation and net operating loss carryover.

Rebuttal: The provisions of California tax law that supporters of separate 338 election complain about apply to all taxpayers. But the "nowhere income" loophole benefits only multistate corporations; of the 318,000 C corporations that file California tax returns, only about 56,000 are multistate businesses. It is unfair for large multistate corporations to create "nowhere income" that totally escapes state taxation, thus shifting the corporate tax burden to smaller California-only firms and to individual taxpayers.

Revenue effect: About \$30 million a year are lost to this loophole.

2. Review tax loopholes as part of the budget.

To improve the fairness of the State's tax code and assure that tax loopholes achieve their intended purpose, California should review its tax loopholes as part of the annual budget process. The governor should identify all tax loopholes in his annual budget submission; report on the purpose of each tax loophole; provide data on whether it is meeting that purpose; and recommend to the Legislature whether it should be continued, modified or repealed. Legislative fiscal committees shall annually review those recommendations as budget priorities and weigh the value of tax loopholes against other state programs and the need for fiscal responsibility.

Assemblyman Mark Ridley-Thomas has already introduced AB 990, which would require the state Department of Finance to issue an annual report on tax loopholes, which would be considered by legislative budget committees as part of their budget deliberations.

Background: California has two budgets, one publicly discussed and approved each year, the other rarely noted. The first budget is the annual plan of spending submitted by the governor to the Legislature. It sets the priorities for direct spending for services and assistance to state institutions and individuals. Lawmakers and the governor annually decide how much to give to each program, and the budget process is supposed to provide an opportunity to review whether the dollars being spent are achieving the goals originally set out in law.

The second is California's tax loophole budget: the collection of deductions, credits, exclusions and exemptions from the personal income tax, bank and corporation tax and sales tax that have been passed over the years to encourage certain activities and benefit certain groups. Just as the spending budget promotes social goals like housing and health care through direct programs, the tax loophole budget is supposed to promote social and economic goals by offering tax breaks to individuals and businesses for particular purposes.

But unlike the spending budget, tax loopholes are not subject to regular review and re-approval. The Legislature and successive governors have passed loopholes to deal with a perceived problem, or because of lobbying by a politically powerful group. According to the Department of Finance, the Legislature and successive governors approved 56 tax loopholes of \$5 million or more between 1990 and 2001, with a total annual revenue cost to the state of \$2 billion. This represents a significant share of the \$8 billion in current year revenue loss from all tax cuts enacted since 1991, excluding the Vehicle License Fee reduction. Seventy-seven percent of this benefit goes to the wealthiest Californians and corporations. (See Attachment A.)

Though frequently enacted, tax loopholes only infrequently carry sunset provisions or requirements that they be reviewed for effectiveness. They are rarely repealed when they are not serving the intended purpose or are a lower priority than critical State investments. Between 1990 and 2001, only four tax loopholes of more than \$5 million were repealed, with four more disappearing because of sunset provisions. (One tax loophole enacted between 1990-2001, the manufacturers investment credit, expired this year because it had not met a job creation target in the original bill). A major factor in the persistence of loopholes is the State constitutional rule on legislative vote requirements for taxes. It takes only a majority vote of the Legislature to pass a loophole, but it requires a two-thirds vote to repeal one.

3. Study water's-edge election by multinational corporations.

The State should give special attention to the water's-edge election by multinational corporations under the bank and corporation tax. The Legislature should require the FTB

to report on whether changed global economic conditions and the diminishing yield of the corporation tax require changes in the water's-edge election.

Background: Since 1986, California law has given multinational corporations the option of computing their tax liability on the basis of either their worldwide income or their U.S. income only (inside the water's edge). The Franchise Tax Board estimates that eliminating the water's-edge election would increase revenues by about \$400 million a year. In the 2001 tax year, 5,714 corporations (about 1 percent of all corporations) elected to file a water's-edge election, out of a total of 56,000 corporations that apportion their income across multiple states or countries. The FTB reports that 87 percent of the benefit of the water's-edge election, \$350 million a year, goes to corporations with annual gross receipts over \$1 billion.

The Legislature approved the water's edge election after warnings from foreign multinational corporations in Japan, Great Britain and Canada that California's worldwide method of determining corporate income would discourage foreign investment in California.

But the world economy has changed significantly in the last two decades. Corporations have become increasingly globalized. According to United Nations statistics, a decade ago there were 37,000 international companies with 175,000 foreign subsidiaries; last year, there were 64,000 multinational firms with 870,000 subsidiaries. More than half of international trade now occurs internally within multinational firms, and more of that trade is service-oriented and involves hard-to-price intangibles like brands and patents. The Internet and electronic commerce have created a world in which place has come to matter less in production, service delivery and employment, giving more opportunities for corporations to move income to tax havens. According to a recent report by the U.S. General Accounting Office, in 2000 U.S. corporations paid only \$14.75 in federal corporate taxes for every \$1,000 in gross revenue, a rate that fell steadily during the late 1990s economic boom.

The availability of the water's-edge election potentially rewards the movement of jobs and corporate income to subsidiaries outside the water's edge. California should determine whether, in a changed global economy, the water's-edge election is still warranted or needs changes. This proposal would require the FTB to report on, among other things, whether corporations are moving income offshore to reduce their California tax liability. The report, which would be due September 1, 2005, would look at issues like whether the water's edge should be redefined to include Puerto Rico and nations frequently used as tax shelters.